nternal Revenue Service

# memorandum

TL-N-5987-91
CC:TL:TS/P
TJKANE/lmr

date: JUL - 8 1991

to: District Counsel, Houston
Attn: Elizabeth Chirich

from: Chief, Tax Shelter/Partnerships Branch
Tax Litigation Division

subject [redacted]
TL-N-5987-91
CC:TL:TS/P Kane Wilson

This is in response to your request for Tax Litigation Advice received by this office on April 15, 1991.

ISSUES

1. Whether, when, and to what extent do certain shareholders/creditors ("Shareholders") of [redacted] realize income from [redacted]'s repayment to [redacted] of the Shareholders' loans under the facts described below?

2. Whether the income, if any, that results from [redacted]'s repayment of the Shareholders' loans is ordinary or capital in nature?

3. Whether the proposed adjustments relating to the loan repayments and their characterization should be made pursuant to a Notice of Final S Corporation Administrative Adjustment ("FSAA"), an affected item notice of deficiency, or both?

CONCLUSIONS

1. The Shareholders will realize income when [redacted] repays the Shareholders' loans to [redacted], assuming that the Shareholders and not [redacted] were the true borrowers of the funds and that the Shareholders' loans were bona

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fide debt and not equity. Once the exact number of loans has been determined and the terms of the loans ascertained, the bases of the outstanding loans at the end of each year is reduced pro rata due to the Shareholders' utilization of losses. Assuming that the repayment of specific loans can be identified, when the loans were repaid by [redacted], the Shareholders realized income using the specific identification method, i.e., income is calculated based upon the adjusted basis of each loan that is repaid.

2. The income, if any, that results to the Shareholders from the loan repayments is ordinary income.

3. The amount of the loans and the amount of the loan repayments are TEFRA subchapter S items, and proposed adjustments must be made through the issuance of an FSAA. The amount of any resulting income to the Shareholders as a result of the loan repayments and the ordinary character of any resulting income to the Shareholders are affected items, and the proposed adjustments relating to these issues must be made using an affected item notice of deficiency after the conclusion of the TEFRA proceedings.

## FACTS

According to the information that accompanied your request, the facts are as follows:

[redacted] was incorporated in [redacted], and a subchapter S corporation election was made on its behalf by its shareholders on or about [redacted].1/ At the time of its incorporation and through the end of its first taxable year [redacted], [redacted] had [redacted] shareholders, whose ownership percentages and initial capital contributions were as follows:

| Shareholders | % | Capital Contribution |
|---|---|---|
| [redacted] | [redacted]% | $ [redacted] |
| [redacted] | [redacted]% | [redacted] |
| [redacted] | [redacted]% | [redacted] |
| [redacted] | [redacted]% | [redacted] |
| [redacted] | [redacted]% | [redacted] |
| [redacted] | [redacted]% | [redacted] |
| | [redacted]% | $ [redacted] |

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1/ It is assumed herein that the subchapter S election was valid in all respects.

On [redacted], [redacted], [redacted] and [redacted] (the aforementioned Shareholders), individually and collectively, acquired an $[redacted] line of credit from [redacted], and on or before [redacted], the Shareholders loaned $[redacted] of said amount to [redacted] ($[redacted] on [redacted], $[redacted] on [redacted], $[redacted] on [redacted] and $[redacted] on [redacted]).2/ This had the effect of increasing the Shareholders' respective total bases to $[redacted] ([redacted] and [redacted]) and $[redacted] ([redacted]).

[redacted] sustained a net operating loss for the taxable year ending [redacted]. Pursuant to section 1367(a) of the Internal Revenue Code, the Shareholders respective bases in their [redacted] shares were reduced to [redacted]. Then, pursuant to I.R.C. § 1367(b), the bases in their respective outstanding loans to [redacted] were reduced. Thus, at the end of [redacted], each Shareholder had a [redacted] basis in his [redacted] stock, and [redacted], [redacted] and [redacted] had a basis in their loans to [redacted] of $[redacted], $[redacted] and $[redacted], respectively. It is our understanding that basis at the end of [redacted] is not an issue here.

During [redacted] and [redacted], the Shareholders loaned the remaining $[redacted] on the [redacted] line of credit to [redacted] (no exact breakout of specific amounts or specific dates has been provided). The Shareholders apparently allocated the $[redacted] loaned in [redacted] to their respective accounts in the same fashion as they did for the [redacted] loan(s). Thus, [redacted] and [redacted] each were allocated $[redacted] of the [redacted] loan(s), and [redacted] was allocated the remaining $[redacted].

In [redacted] and [redacted], [redacted] paid directly to [redacted] $[redacted] and $[redacted], respectively, thereby reducing the outstanding loan balance between the Shareholders and [redacted]. Each repayment to [redacted] also provided for interest in the amounts of $[redacted] and

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2/ Although it appears there were no written documents evidencing the loan to [redacted], the Shareholders apparently considered the $[redacted] to have been loaned by each of them in proportion to their respective ownership interests in [redacted]. Thus, [redacted], having a [redacted]% ownership interest in [redacted], was responsible for [redacted]% of the $[redacted], or $[redacted]. Although in the absence of any express agreement it could be argued that each of the Shareholders were responsible for equal portions of the $[redacted], we have not been asked to address this issue. In any event, the allocation of the initial $[redacted] was recorded on the books of [redacted] in the manner described above, thus implying that the percentage split was at least tacitly agreed to by the shareholders.

$[redacted], respectively.3/ Shareholders [redacted] and [redacted] completely terminated their ownership interests in [redacted] as of [redacted] (presumably by way of redemptions).4/ For the taxable year [redacted], [redacted] incurred a net operating loss in the amount of $[redacted].

DISCUSSION

Issue 1

As a preliminary matter, we note that the repayments by [redacted] to [redacted] have been treated as repayments to the Shareholders on their loans to [redacted] followed by repayment from the Shareholders to [redacted]. Subject to our comments below, we belive this recast is appropriate.

Based upon our research, it appears that the specific issue to be addressed in Issue 1 has not been formally addressed in this detail to date. Although Smith v. Commissioner, 48 T.C. 872 (1967), characterized the amount at issue as "loans", from the description of the facts and the resolution of the issues in Smith it is impossible to discern whether the "loans" were made up of single or multiple loan transactions by the shareholders. Additionally, in holding that each repayment of the open account shareholder loans by the small business corporation to its shareholders was allocable in part to return of basis and in part to income based upon the following formula,

$$\text{Income} = \text{Payment} \times \frac{\text{Face amount} - \text{basis}}{\text{Face amount}}$$

the Smith court did not specifically address whether or if the "face amount" referred to was the total face amount outstanding at the end of each year or whether it was referring to some identifiable portion thereof. Therefore, although Smith acts as the starting point of our analysis, we must extrapolate the holding of the Smith case in order to apply it to our particular facts.

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3/ It is unclear what, if anything, was being done in terms of accounting for the interest on the loans to [redacted] from the Shareholders.

4/ Thus, the TEFRA provisions may not be applicable to [redacted] for its [redacted] taxable year. Temp. Treas. Reg. § 301.6241-1T(c)(ii).

The revenue agent has applied the Smith formula to the loan repayments in year two as if the year one and year two loans in toto constituted a single loan. Although this may be a convenient method for resolving the issue, we agree with your conclusion that this approach is inappropriate. However, our analysis goes much further than yours, and we recommend that the loans be segregated, if possible, into their separate components and considered retired based upon the following discussion.

Initially, it is noted that the exact terms of the Shareholder loans have not been established. The terms of the agreement purportedly between the Shareholders and [redacted] should be ascertained. Determination of those facts is necessary because if [redacted], and not the Shareholders, was the true borrower of the funds, the shareholders would not be entitled to rely on the existence of the "loans" to [redacted] for purposes of utilizing any distributive share of the losses incurred by [redacted]. I.R.C. § 1366(d)(1). See, e.g., Griffith v. Commissioner, T.C. Memo. 1988-445 (a shareholder was not permitted to utilize a portion of the loss of a subchapter S corporation where the journal entries on the corporation's books had substituted the shareholder as the creditor when the shareholder was not the true creditor) and Blackman v. Commissioner, T.C. Memo. 1981-244 (shareholder guarantees of bank loans made to a subchapter S corporation are insufficent to permit the shareholder to utilize corporate operating losses at the shareholder level). If the Shareholders and not [redacted] were the true borrowers of the funds from [redacted], then in the absence of any specific terms associated with the loans by the Shareholders to [redacted], I.R.C. § 7872 would impute certain of the terms of such loans for Federal income tax purposes.5/ We suspect, however, that if the loans to [redacted] were bona fide loans,

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5/ I.R.C. § 7872 imputes interest for Federal income tax purposes at the applicable Federal rate to certain enumerated below-market loans, one category of which is corporation-shareholder loans. I.R.C. 7872(c)(1)(C). Although the corporate-shareholder loans are generally subject to a $10,000 de minimis exception, the de minimis exception is not applicable to any loan the interest arrangements of which have as one of their principal purposes the avoidance of any Federal tax. I.R.C. § 7872(c)(3). Treas. Reg. § 1.7872-4(e) defines a tax avoidance loan as including one where a principal factor in structuring the transaction as a below-market loan is to reduce the Federal tax liability of the lender. Because the Shareholders' loans in question allow the Shareholders to utlize corporate losses at the Shareholders' level, thereby reducing their Federal tax liabilities, the provisions of I.R.C. § 7872 should be applicable to the Shareholder loans if they are below-market without regard to the de minimis exception.

the Shareholders would have made the loans to [redacted], expressly or implied on substantially the same terms as the [redacted] loan.

If it is determined that the Shareholders are the true borrowers of the funds from [redacted] a debt/equity analysis should be made in order to determine whether the contributed funds constituted bona fide debt or should be treated as equity for Federal income tax purposes. See I.R.C. § 385 and B. Bitker and J. Eustice, Federal Income Taxation of Corporations and Shareholders, para. 4.04 (4th ed. 1987 & Supp. 1991). A classification as equity could result in qualification problems with respect to [redacted]'s subchapter S corporation status because the reclassified equity could constitute a prohibited second class of stock that might not qualify for the straight debt safe harbor. See I.R.C. § 1361 (b)(1)(D) and (c)(5) and Prop. Treas. Reg. § 1.1361-1(l) 3 and 4.

Finally, the factual clarification of the underlying loan or loans is necessary for several other reasons as well. It is not clear whether the entire $[redacted] line of credit from [redacted] was drawn down by the Shareholders at one time, i.e., in late [redacted], or was drawn down on an as-needed basis, such as when the funds were actually contributed to [redacted] Typically, lines of credit are granted to business concerns in order to enable those concerns to finance their business needs, e.g., to help meet seasonal business pressures. Lines of credit generally specify the maximum amount that can be borrowed under such arrangement over a given period of time and what rate of interest is to be charged. That rate usually a varies, typically in conjunction with the lender's prime rate. See, e.g., The Bankers Handbook, 613-21 (rev. ed. 1978) (copy attached). Depending upon the financial status of a particular debtor and its creditor, as well as the nature and extent of their relationship, it is our understanding the the interest rate that is applicable to any particular outstanding line of credit is subject to the typical workings of the marketplace. As an example, a variable rate can be applied to an average daily loan balance outstanding. As another example, a different rate of interest can be charged with respect to that portion of an outstanding loan balance that exceeds a certain threshold amount. Finally, a borrower may be required to pay a fixed rate of interest on a specific portion of an outstanding loan balance based upon the lender's cost of capital when that specific portion of the loan was made. Thus, each of the specific loans made to [redacted] in late [redacted] and early [redacted] may have to be treated as separate loans with separate terms for purposes of your basis reduction/income analysis. This would result in having to extend the bifurcation formula that you have suggested even further: There may not be [redacted] loans, one in [redacted] and [redacted] in [redacted], but possibly [redacted] loans in [redacted] and more than [redacted] in [redacted]. And presumably the pro rata formula for calculating income used in Smith would be equally applicable to the converse, *i.e.*, reducing the basis in the outstanding loans when the net operating losses are utilized at the shareholder level.6/ (Thus, as specifically identifiable loans are subsequently repaid, as discussed below, any further original pro rata reduction of basis in each loan would have an impact on the timing and amount of income that is subsequently recognized on repayment.)

Having determined that the total loan balance should be bifurcated into separate and distinct loan amounts to the fullest extent possible, with the adjusted basis of such loan or loans being reduced in the manner and method stated above, it does not necessarily follow that any repayment of an outstanding loan or loans must be prorated in some fashion as well. This is because although the method of reducing the adjusted basis in the outstanding indebtedness is done pursuant to the operation of law, the repayment of any specific part or portion of such indebtedness is presumably within the control of the parties, either through the terms of the indebtedness or by express agreement between the parties. *Cf.* *Cornelius v. Commissioner*, 58 T.C. 417 (1972), *aff'd*, 494 F.2d 465 (5th Cir. 1974) (loans treated as separate loans and not netted together when loans outstanding at the beginning of a taxable year and which had reduced bases were completely repaid before other loans were made by the same shareholders prior to the end of that same taxable year). In the absence of any agreement on this point, which may be unusual, it would be reasonable to assume that the debtor would attempt to retire the indebtedness that has the least favorable terms to it while the creditor will attempt to retire the indebtedness with the most favorable terms to the debtor.

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6/ There are no regulations interpreting I.R.C. § 1367(b)(2), the current law provision providing for the reduction in the basis of the outstanding indebtedness. However, I.R.C. § 1367 was enacted as part of the Subchapter S Revision Act of 1982 (P.L. 97-354), and essentially replaced prior law section 1376, which provided substantially similar rules (though much less detailed) as those in I.R.C. § 1367 for increasing and decreasing the basis of stock and indebtedness. In interpreting prior law section 1376(b), Treas. Reg. § 1.1376-2(b)(2) (1959) generally provided that the reduction in the basis of the indebtedness of a shareholder applied to the outstanding indebtedness as of the close of the corporation's taxable year or the last day the shareholder was a shareholder, if earlier; Treas. Reg. § 1.1376-2(b)(3) (1959) provided that such reduction "shall be applied to each such indebtedness in proportion to the basis of the various debts." Although these regulation provisions do not interpret I.R.C. § 1367, we see no reason why this particular rationale should be any different under I.R.C. § 1367 as it was under former section 1376.

The records of [redacted] would undoubtedly be helpful in this regard.

We believe that it is incumbent upon the taxpayer to demonstrate not only the terms of the indebtedness but the manner, method and sequence of repayment. In the absence of the taxpayers' ability and/or willingness to do so, and if (for whatever reason) you are unable to uncover the same, we believe that the terms of the indebtedness between a shareholder and the corporation should be set, to the extent possible, using the approach described above, including, if necessary, the application of the principles of I.R.C. § 7872.7/ This approach would most closely resemble the workings of the market place in the normal commercial context.

Issue 2

We agree with your conclusion that the income to the Shareholders as a result of [redacted]'s payment to [redacted] should be ordinary income and not capital gain. Recasting the loan repayment as we have done in Issue 1 above, the transaction is essentially the same transaction that was at issue in Smith v. Commissioner. In Smith, the shareholders, after having their basis in the open account debt reduced by virtue of basis adjustments attributable to subchapter S corporate net operating losses, received payments from the corporation in reduction of the indebtedness. Smith held that amounts received by a shareholder were allocable in part to a return of basis and in part to income using the formula discussed in Issue 1 above. In Rev. Rul. 68-537, 1968-2 C.B. 372, the Smith case was cited as authority for the proposition that repayment of a debt on open account results in ordinary income treatment, thereby distinguishing Rev. Rul. 64-162, 1964-1 C.B. (Part I) 304, which holds that capital gain treatment results when the underlying debt is evidenced by a note.8/ See also Barr v. Commissioner, T.C. Memo. 1980-3 (all loan repayments were considered to have been made on open account loans, and therefore resulted in ordinary income treatment and not capital gain, when the taxpayers failed to prove that any of the repayments were made on loans which were evidenced by promissory notes). Rev. Rul. 68-537 and Smith squarely support the conclusion that the income in

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7/ Presumably the interest income to the shareholder and interest expense to the corporation has to be correctly calculated in any event, and I.R.C. § 7872 would be the appropriate default mechanism to resort to under these circumstances.

8/ The G.C.M. underlying Rev. Rul. 64-162, G.C.M. 32,801 (March 2, 1964) is totally conclusory in nature and is barely over 1 page in length. There is no G.C.M. underlying Rev. Rul. 68-537, which is a digest ruling (meaning that there is no rationale presented in the ruling to support its holding).

question should be characterized as ordinary income and not capital gain income.

Issue 3

Assuming that the indebtedness is bona fide shareholder debt and that its repayment results in the recognition, to some extent, of ordinary income to the Shareholders, the appropriate adjustments must be proposed in the proper manner.

The purported loans made by the Shareholders to [redacted], the impact of Federal income tax implications of such repayment to the Shareholders, and the character (i.e. repayment of debt, equity, etc.) of the income, if any, recognized by the Shareholders upon such repayment, are all subchapter S items. See Temp. Treas. Reg. § 301.6245-1T(a)(1)(v) (corporate liabilities (including determinations of the amount of the liability, whether the corporate liability is to a shareholder of the corporation, and changes in the liabilities from the preceding year) are subchapter S items); Temp. Treas. Reg. § 301.6245-1T(a)(5) (items relating to the amount and the character of the amount of contributions to the corporation and distributions from the corporation are subchapter S items); Temp. Treas. Reg. § 301.6245-1T(c)(2)(i) (for purposes of Temp. Treas. Reg. § 301.6245-1T(a)(5), the character of an amount contributed to a corporation includes determining whether it is a contribution, loan, or repayment of a loan); and Temp. Treas. Reg. § 301.6245-1T(c)(3)(i) (for the purposes of Temp. Treas. Reg. § 301.6245-1T(a)(5), the character of an amount transferred to a shareholder includes determining whether it is a dividend, compensation, loan or repayment of a loan). Additionally, for the purposes of Temp. Treas. Reg. § 301.6245-1T(a)(5), contributions from a corporation include a determination of the amount of money involved. See Temp. Treas. Reg. § 301.6245-1T(c)(2)(ii) and (3)(ii), respectively. Because the amount of the distributions (or in this case, deemed distributions) and their character are subchapter S items, the adjustments relating to these items can be properly made in an FSAA.

Although the temporary regulations are somewhat detailed in defining and/or describing what subchapter S items are or can be, the temporary regulations provide little, if any, guidance as to what items are not subchapter S items or how to classify and treat the excluded items or categories of items. The temporary regulations explicitly exclude only 1 category of items from qualifying as subchapter S items and, conveniently for us, that category happens to be basis. Temp. Treas. Reg. § 301.6245-1T(c)(3) provides, in part, that:

> To the extent that the determination requires other information, however, that item is not a subchapter S item. Such other information would include the

> determination of a shareholder's basis in the shareholder's stock or in indebtedness of the S corporation to the shareholder. (emphasis added)

See also Dial USA, Inc. v. Commissioner, 95 T.C.1 (1990). Thus, the bases that the Shareholders had in their respective indebtedness, and therefore the amount of income to each Shareholder as the result of the loan repayments by [redacted], are not subchapter S items. (Nevertheless, even though basis is not a subchapter S item, there are components of basis that are subchapter S items. Thus, care must be taken to ensure that a proper distinction is made under any given set of circumstances between the amount of basis and appropriate ajustments to items that are includable components of basis.) The ordinary or capital gain character of the income, if any, to each Shareholder should likewise fall into this same category. This is because the character of any income recognized at the Shareholder level can only be determined concurrent with or after a determination of the amount of income to be recognized, which depends upon the adjusted basis each Shareholder has in the outstanding loans. That is, the character of income cannot be determined until after it has been determined that there is income to begin with. The amount of income and its character would then fall into the affected item category and, upon conclusion of the TEFRA proceedings, an affected item notice of deficiency could then be issued to the Shareholders which would take into account all of the adjustments that were finally determined in the completed TEFRA proceedings.9/ Those items determined in the TEFRA

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9/ Our statement here that "presumably" affected item treatment applies highlights a potential litigation hazard that is present in all TEFRA cases involving subchapter S corporations. Unlike the TEFRA partnership provisions, which specifically set forth a statutory and regulatory scheme for affected item treatment, the TEFRA subchapter S provisions make no mention of affected item treatment. Although it may be possible to read the language in I.R.C. § 6244 that states that "so much of the other provisions of this subtitle as relate to partnership items, are . . . hereby extended to and made applicable to Subchapter S items" as authority for applying the partnership affected item provisions to subchapter S corporations, the reference to a specifically defined term, i.e., partnership items, to the exclusion of another specifically defined term, i.e., affected items, presents a statutory construction problem that cannot be readily explained away. Although the broad context of the TEFRA provisions in toto could lead to an intuitive conclusion that the subchapter S provisions must have an affected item concept, there is no apparent concrete legislative or regulatory support for this conclusion. Indeed, given the way the statute is drafted, it is arguable that we may not have the delegated authority to draft regulations providing proceeding would be res judicata in the subsequent affected item proceeding and only shareholder components of basis would need to be determined. See N.C.F. Energy Partners v. Commissioner, 89 T.C. 741, 747 (1987). However, it is still appropriate in an affected item proceeding to take into account partnership documents and records when analyzing the ordinary capital gain character of the income. See Roberts v. Commissioner, 94 T.C. 853, 862 (1990).

If you have any questions, please do not hesitate to contact Thomas J. Kane at FTS 343-0032.

CURTIS G. WILSON

Attachment:
As noted

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for affected item treatment under any circumstances. Nevertheless, we note that in Dial USA, Inc. v. Commissioner, 95 T.C. 1 (1990), the Tax Court proceeded under the assumption that the TEFRA subchapter S provisions provide for affected item treatment. Unless and until we are favored with some type of solution, legislative or otherwise, we have no choice but to proceed in these matters as if the TEFRA subchapter S provisions specifically provide for affected item treatment.